

DOUBLE BUBBLE, TECH + TROUBLE

ETFs IN THE US HAVE BECOME CONCENTRATED WITHIN A HANDFUL OF TECHNOLOGY SHARES, LEADING TO WIDESPREAD EXPOSURE TO REGULATORY RISK AND OTHER DANGERS OPPORTUNITY KNOCKS.

As the nine-year bull market has progressed, US index fund investors' excessive dependence on a hyper-narrow band of technology stocks has taken us to the precipice. The investment universe has not before seen so much capital concentrated in a single sector that, via convenient products, can be sold at the click of a mouse.

Meanwhile, the emerging perception of regulatory risk will remind investors that projecting hyper-rates of return on equities out to infinity to justify stratospheric share prices is not a valid investment methodology.

Last year, during presentations to financial planners and their clients around the country, we began underscoring several important observations.

The first was that the proportion of the market's high returns delivered by a handful of mega-cap tech stocks was historically unprecedented. The second was that as index exchange-traded funds grew, they were forced to invest ever-greater amounts in these larger companies, irrespective of price or profit outlook. Finally, we noted that the stock turnover of the major US index ETFs was significantly higher than the turnover of even their largest holdings.

While this would lead to a combination of high returns and low volatility on the way up, the reverse would be true when investors begin exiting.

We appear to be at a fork in the road. There will be overreactions as higher-quality tech companies

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are thrown out with the proverbial bath water. Such events will present opportunities for savvy investors. There will also be traps, and here we alert investors to the dangers of heavily tech-weighted US index funds – arguably one of the biggest fads investors have seen. The over-reliance, by US ETF investors, on the prospects of a narrow band of tech companies will again present mouth-watering opportunities.

THE TECH STORY SO FAR

The emerging perception of increased regulatory risk for FAANG stocks (Facebook, Apple, Amazon, Netflix and Alphabet's Google) has not only capped prices, it also has served as an important reminder that excess profitability cannot be extended indefinitely and will always come up against an opposite force.

Google is listed among the 10 most valuable companies in the world; it dominates search with a 90 per cent share. Facebook commands 88 per cent of social media traffic in the US. By some accounts, nearly half of Americans get their news from Facebook. By 2016, the share of online

US consumers bypassing search engines in favour of shopping on Amazon was 55 per cent, and the biggest Chinese tech companies, such as Tencent and Alibaba, command similar or even larger shares.

As recently as February, the NYSE FANG+ Index stocks (Facebook, Apple, Amazon, Netflix, Google, Alibaba, Baidu, Nvidia, Tesla and Twitter) were collectively valued at multiples three times that of the broader market. The divergence is even greater than at the peak of the tech bubble in 2000.

While the S&P 500 has advanced a phenomenal 331 per cent in the nine years since the 2009 lows, Amazon is up more than 2100 per cent, Apple over 1100 per cent, Netflix by 5300 per cent and Google parent Alphabet by 586 per cent. Add Facebook, Microsoft and Nvidia to that list and these stocks now account for more than 15 per cent of the entire S&P 500, and just shy of half the NASDAQ 100.

Despite regular praise during the recent tech boom, the underlying business models of many operators remain unviable without the support of private equity injections at increasing valuations. Where this is the case, investors need to be especially cautious. Tesla and Uber, for example, continue to be loss-makers, despite US\$50 billion (\$66 billion) and US\$60 billion valuations, respectively.

Perhaps consequently, a tectonic shift in sentiment towards many tech giants is emerging, spooking investors amid not only a more cautious mood and an extended wait for profits to emerge, but also a barrage of negative headlines in the face of political and regulatory backlashes.

One wonders whether Jeff Bezos could one day be listed among the most loathed people in the world.

SHIFTING SANDS

George Washington wrote: "It is in the very nature of power that it will expand until it is checked by an opposite power."

The abuse of power is as old as human history itself, so it was inevitable that – through mismanagement or otherwise – the largest companies in the world, those that were also the fastest-growing and therefore the least experienced, would be in the sights of global regulators.

Mark Zuckerberg and his Facebook have been ensnared in an investigation into Russian-backed election tampering. Facebook's market capitalisation had fallen by US\$100 billion from its February 1 high at the time of writing.

Elsewhere, European Union antitrust chief Margrethe Vestager fined Alphabet's Google €2.4 billion last June for abusing its dominance in search engines to favour its online shopping service. That finding has triggered a wave of similar



INVESTORS ARE PERHAPS UNAWARE JUST HOW EXPOSED THEY ARE TO THE DIRECTION OF JUST A FEW TECH NAMES

investigations against Google. In the US state of Missouri, Attorney General Josh Hawley has launched his own antitrust investigation into the same allegations and has demanded a copy of all evidence Google gave the EU.

On August 30, 2016, the EU ordered Apple to pay €13 billion in allegedly unpaid taxes to Ireland. Facebook was fined €110 million in May 2017 for misleading the EU during a review of its acquisition of messaging unit WhatsApp. On October 4 last year, the EU ordered Amazon to pay €250 million in allegedly unpaid taxes to Luxembourg, and in January this year, Qualcomm received a €997 million antitrust fine for alleged illegal payments to Apple to ensure that Apple devices exclusively used its chips.

Meanwhile, Amazon has been openly attacked by US President Donald Trump on Twitter; Tesla and Uber's autonomous vehicles have killed people, setting back projected start dates for an autonomous driving future; and Airbnb hosts are being constricted by conditions limiting short-term leasing.

A more strategic approach to dealing with the influence of tech giants is also under way. In the US, the Democrats – who were defeated at the last election arguably because they cosied up to big business – are returning to their roots ahead of the November midterms, with an election blueprint and new economic agenda called *A Better Deal*. The section titled "Cracking down on corporate monopolies and the abuse of economic and political power" is focused entirely on antitrust enforcement and merger law – the most important but arguably weakest component of America's competition policy.

Equally worrying for tech giants and their investors, in December 2017, the US Senate Judiciary Committee's Subcommittee on Antitrust, Competition and Consumer Rights conducted a hearing that also examined the "consumer welfare" standard that is the bedrock of antitrust enforcement, with some arguing that antitrust actions would be better framed and served if the measure were "economic and political power" rather than "consumer prices".



A SHIFT IN SENTIMENT TOWARDS MANY TECH GIANTS IS EMERGING, AMID AN EXTENDED WAIT FOR PROFITS TO EMERGE AND A BARRAGE OF NEGATIVE HEADLINES IN THE FACE OF POLITICAL AND REGULATORY BACKLASHES

Also, US politicians are now being goaded by media to do much more. US journalist Barry Lynn perhaps personifies this sentiment. He suggests that in the 2020 presidential race, antitrust policies should be a top issue for debate among the candidates. Speaking to tech journal *Calcalist*, Lynn observes: "I see no reason why it shouldn't be the top issue. It's tied to everything. Do you want to know why your job sucks, why your wages are down, why you can't start a business? There's a reason for that."

Late last year, congressman Keith Ellison, co-chair of the Democratic National Committee, introduced legislation, including the 21st Century Competition Commission Act, that would fund investigations into the impact of corporate mergers and increasing market concentration.

Meanwhile, in a decision with far-reaching consequences for many sharing-economy tech companies, Europe's highest court, the Luxembourg-based Court of Justice of the European Union, responded to a complaint by a Barcelona taxi drivers association that wanted to prevent Uber from setting up in the city. The Court of Justice agreed that Uber drivers should have authorisations and licences and be regulated like a transport company – not a technology service.

In Europe, a set of sweeping reforms under the banner of the General Data Protection Regulation will be established in May. Under the GDPR, European residents will have control over how their digital data is used and arranged, including the "right to be forgotten". They will have the power to remove or update data on company servers, and be able to request the data and port it to another company.

On Monday, April 2, FAANG stocks lost US\$78.7 billion (\$104.1 billion) in market value.

TECH-LADEN INDICES

As recently as the last quarter of 2017, almost half of the NASDAQ 100 constituents were trading on P/E ratios of more than 200. To get to that point, their prices had to rise stratospherically. Further, the S&P 500 Growth Index has a 41 per cent weight

to technology and the Russell 1000 Growth Index has a 39 per cent weight. Together, they average a 60 per cent active weight to tech versus the S&P 500 Index. That is a huge bet and investors are perhaps unaware just how exposed they are to the direction of just a few tech names. Of course, the more concentrated the group of winners has become, the more difficult it has become for active fund managers to outperform tech-dominated indices. The flows into ETFs have understandably accelerated.

Exchange-traded index fund operators such as Vanguard and State Street Global Advisors weight their products according to market capitalisation, so index funds become increasingly concentrated and exposed to the largest names – those companies that have already risen stratospherically. This time around, these names tend to be tech names, and as they outperform the broader market, more money flows into them, fuelling even more buying of them.

CONCLUSION

A tide of money is flowing into ETFs without any research or concern for prospects and value. That tide is driving, nay distorting, asset prices globally.

It is my personal view that the ETF bubble is the transmission mechanism for a technology share bubble. As funds flowed into ETFs at a record-setting pace that peaked in March, ETF operators were forced to buy an ever-narrowing band of winners. As tech shares rocket higher, those operators are forced to buy more amid a self-reinforcing circle of enthusiasm.

The trillions of dollars flowing into ETFs are distorting all asset prices and those who have invested in US index ETFs, believing they are diversified, are no more protected than the municipal funds that invested in mortgage-backed collateralised debt obligations and believed geographic diversification would protect them from default.

This is ironic, given the popularity of ETFs after 2007 was fuelled by participants desiring less sector risk, less company-specific or idiosyncratic risk and less manager risk.

As the indiscriminate index investing fad unwinds, volatility will increase, and many investors will realise substantial losses; however, active, value-oriented players with insight will be able to take advantage of a relatively rare over-reaction that will set them up for another decade. The ideal window to switch from passive index funds to value-oriented active fund managers may not be open for long. ■

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